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Market readies for Thames Tideway Tunnel's IP structure

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Bidding is underway for the construction contracts for London's new Thames Tideway Tunnel project, and its greatly anticipated tender now seems imminent.

The specifics of the how the so-called Infrastructure Provider (IP) structure for the new £4 billion ($6.7 billion) "super sewer" will work are yet to emerge however and the release of tender documents has fallen back from May to June.

The project is to build and operate a new 25km sewage tunnel under the centre of London, over a period of eight years, to divert raw sewage from overspilling into the Thames. The cost is likely to be met with roughly £1 billion of upfront equity from the winning bidder and £3 billion of debt.

A hybrid utility

UBS as financial adviser is marketing the IP financing vehicle to the market. UBS has presented the outline of a hybrid format, which bears great resemblance to the sale of an operational water utility.

As is the case for a water utility, the IP will finance the costs of construction through additional charges to customer bills (in this case added to the bills of Thames Water customers on the IP's behalf). The IP will hold its own license from UK water regulator Ofwat, and Ofwat will regulate the charge to customers under the five-year regulatory cycle. The current estimate is for an additional £40 per year on individual customers bills.

Circling to bid are major global sovereign wealth funds, national pension funds, insurance companies and large infrastructure funds, such as ones which are already shareholders of UK private water utilities. About 12 or 15 are known to be looking to bid, from Asia-Pacific, the Middle East, Canada and Europe. In the last month some consortiums have begun to form in anticipation of the tender.

A greenfield project

The long-dated and regulated revenue streams of utilities are a great pull to institutional investors, and the IP should already be an operating company when Thames Water awards it in 2015. The £1.6 billion of construction contracts will be in place, the IP will have its own staff (led by CEO Andy Mitchell from Crossrail), a regulatory regime will be established with Ofwat and CH2M Hill is already contracted as project manager for the investors.

Andy Briggs, partner at Hogan Lovells, said: "The aim is to make the structure as mature as possible to incentivise the global funds to view it as an M&A utility transaction. However it doesn't actually have 20 years of operational revenues behind it."

Therein lies a big question for the Thames Tideway Tunnel – just how much can it be viewed as a utility when it is

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essentially an enormous greenfield construction project, and therefore an inherently risky undertaking?

Support for investors

The eight-year construction period is double the length usually seen for greenfield roads projects. The two tunnels will be over seven metres wide and run beneath a network of tube lines and existing utility tunnels. Aside from the high risk of time and cost overruns, construction is divided into three lots, spread over 24 sites, and the IP will have to take on interface risk.

A utility's capital expenditure would usually be in bursts to allow for upgrades to an existing network, whereas the IP needs to make an initial investment of at least £4 billion.

Under the current proposal, investors should bid with an additional 20% contingency budget. The government is committed to ensuring this vital tunnel goes ahead in order to divert 55 million tonnes of raw sewage away from the Thames. Therefore if costs overrun, Thames Water importantly has the ability pass through charges to customers.

In addition, the government has agreed to backstop the project in certain circumstances, though the terms of this support are not finalised. It appears that if costs rise, through no fault of the IP's, and the market cannot lend to the IP on reasonable terms, then government will act as a funder of last resort.

Upfront financing?

The project requires about £3 billion of debt and the bidders could either take out all the financing upfront at financial close, or raise financing in stages over the eight years of construction. Utilities have a practice of issuing bonds and raising loans only as required for capital expenditure or having revolving facilities.

"The bidders have the difficult challenge to work out the most efficient way to finance this," said Briggs.

Long-term bank debt and bonds are both options at this stage. The tenor is not certain ahead of the tender and could be 30 or even 50 years, which banks would struggle to meet.

The negative carry, or interest rate costs, associated with funding a public bond issue upfront are a strain, especially on as large a sum as £3 billion. The investors may choose to issue bonds gradually under a medium-term note programme, or raise further debt later. This would come down at the competitive tender stage to a dependability judgement on investors.

Regulated water utilities enjoy a very liquid market when it comes to raising debt. Therefore future liquidity does not pose a threat to deferring a large part of the financing, but pricing risk does. Interest rates are at a historic low right now, the future is uncertain and the success of the construction progress could affect the pricing a few years down the line.

A forward purchase agreement with banks or bondholders could fix the pricing at financial close for a deferred drawdown schedule, though this option will bear commitment fees over the lengthy construction period.

June tender

Thames Water should award the IP contract in May 2015, ahead of the UK's general election, at the same time as the construction contracts. Further clarity on the tender is due in June, but it already appears that there will be massive global competition for this innovative mega-project.

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